NOTES

VALUATION AND IMPROVEMENTS MADE FROM EARNINGS

In connection with all recent discussions of railroad problems, there has been much controversy over the question, "Shall improvements made from earnings be capitalized or included in valuation?" The answer to this question depends to a degree upon the belief which is held regarding the ownership of net earnings above a so-called reasonable return on the capital directly invested and any property acquired therewith. On this subject diverse views are held.

Regulating bodies have expressed themselves generally as believing that the title legally is in the company. Modifications of this view are advanced to the effect that the public has an equitable interest in the surplus earnings invested in the property from which it may derive benefits through lower rates for the service rendered, through better service, or in other ways.

Judicial determination of this important question is not as conclusive as could be desired. The available decisions bearing upon the subject indicate the court's feeling that net earnings and property derived therefrom are owned by the stockholders.

The railroads believe they have undoubted title to all the property which they possess without regard to the source from which it was produced. This belief carries with it the opinion that all net earnings belong to the stockholders.

Public opinion has been expressed to the effect that all earnings above a reasonable return belong to the public and that property acquired from such excess earnings is similarly circumstanced.

The several viewpoints have been reviewed to assist in a clearer understanding of the discussion which follows and the conclusions to which it leads, which are those of the investment banker.

It is safe to say that the majority of successful businesses have, in large part, been built from earnings which have been retained in the business. It is a well-recognized commercial principle, to which bankers fully subscribe, that only a portion of the profits should be distributed in cash to the proprietors of a business. The balance should be retained to increase working capital, or, in part at least, to provide additions to plant and inventory. These undistributed profits appearing first as a

capital liability, under some such appropriate heading as "Undivided Profits" or "Surplus," are later, in part, converted into capital stock which is distributed as a stock dividend to the stockholders, or sold for cash and the proceeds of the sale distributed in like manner. If the surplus which is capitalized is derived entirely from earnings, and if a liberal amount is retained in the surplus account to meet unforeseen contingencies, this method of building a business and issuing evidences of its growth to the proprietors has full sanction as being conservative and proper.

The foregoing remarks apply to businesses the profits of which are regulated by general conditions, by the competition which they meet, and by the efficiency of their operation. The same regulators of profit apply to the business of selling transportation, and in addition the railroads have for some time had their money-making and other functions regulated by the Interstate Commerce Commission and numerous state commissions. This regulation has benefited the railroads through the restriction of rebates, passes, and other unprofitable and undesirable competitive methods, but it has nearly always seemed to be the assumption of regulating bodies that profits should therefore be restrained, if possible in the accumulation, and if that were not accomplished then in the distribution thereof to the stockholders. That the people must own the railroads if they are to carry regulation beyond certain limits may be stated as a fact, resting upon the sound conclusion that the properties of the railroads belong to the capital from which they were created.

Notwithstanding the public character of the business of the railroads and the regulation to which they are subjected, the same sound business principles should be observed in the conduct of their affairs as would apply to any private corporate activity. It is prudent for railroads to distribute in cash to their stockholders only a portion of their profits, retaining the balance in the form of surplus or undivided profits and investing it in improvements, extensions, or working capital. If this course is pursued an amount of property will be acquired equal to the undistributed profits. Clearly the same kind of title to this property is in the company for the stockholders as that which would be held if the property had been obtained from the proceeds of bonds, notes, or capital stock.

It therefore follows that the earnings from which this property was created are also the property of the stockholders, even though such earnings may be considered as in excess of a reasonable return on the investment. Regulation may recognize this capacity for excessive earnings

and seek to limit future earnings to a reasonable return, but it should not be permitted to take away from the stockholders the earnings of the past. If such a retroactive policy were possible, bankers would be slow to underwrite and investors would hesitate to buy securities which were in part protected by the investment of surplus earnings in property the title to which is insecure. Much has been said in the past two or three years regarding the increasing disinclination on the part of the investor to buy railroad stocks. The result has been a preponderance of railroad bonds and notes until a situation now exists with many railroads in which the debts are out of proportion to the capital and surplus. If the common stocks of railroads are to continue attractive as an investment, buyers must be assured of an average return above that which may be obtained from mortgage obligations. An attractive return can best be provided through the annual payment of a moderate cash dividend, and the further distribution from time to time of additional dividends, preferably in stock which has been obtained from the capitalization of a portion of the surplus earnings invested in the property.

The advocates of a proprietary public interest in railroads' surpluses have a number of serious difficulties to overcome before they reach firm ground. Their assertion that the earnings in excess of a reasonable return are the property of the public immediately provokes the questions: "What is a reasonable return?" and "Who are the public?" No standard has been created, nor is one likely to be, by which a reasonable return may be ascertained. Also, the public is held variously to mean the government, the shippers who contributed the surplus, the future buyers of transportation (whose rates will be lower as a result of the existence of the surplus), and the people generally who may obtain a share in the surplus through heavy railroad taxation.

If this theory of public interest in the surplus is sustained, stockholders will be disposed to distribute all earnings in the form of cash dividends. Surpluses will become meager and dividends irregular. Improvements will be dependent upon the ability to market securities to obtain funds to pay for them. During much of the past two years the securities market has been of comparatively small proportions and improvements have been difficult to finance. The outlook for the future is not encouraging.

In this discussion net earnings and their ownership and disposition have been given the most attention because upon a correct understanding of that phase of the subject will depend the opinion regarding valuation. The investment banker ascertains among other things the

amount and value of the property owned by a public service company, and the relation between that value and the amount of securities outstanding, in forming an opinion as to the soundness of the company's securities. It is not material to him that the property was in part acquired from the investment of net earnings, except as that indicates the conservative policy of the owners. The important facts are the value of the property and the quality of the company's title to it. If, as has been herein asserted, net earnings and property acquired with them are exclusively the company's, then the property so obtained should be included in valuation made for any purpose. If the stockholders prefer to reinvest the profits in the business and do so by leaving them there as surplus, rather than to take them out in cash dividends and put them back again as the purchase price of securities, the resulting additions to the company's property are identical as to ownership, sale value, and value for rate-making purposes. These conclusions seem inevitable.

There are so many collateral phases which have a bearing on the matter under discussion that it would be difficult to exhaust the subject in a paper of reasonable length. It is hoped that the arguments advanced adequately support the conclusions reached, which may be summarized as follows: (1) That net earnings are the property of the stockholders, and, therefore, property acquired with net earnings is likewise the property of the stockholders; (2) that it is better to invest a portion of the earnings in improvements, and subsequently capitalize them after a liberal surplus has been created, than to pay out all net earnings in cash dividends and sell securities to provide funds for all improvements; (3) that valuation has to do with the property owned and not the source from which funds to acquire it were obtained; and (4) therefore, property obtained from net earnings should be included in a valuation for any purpose.

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A RECENT ENGLISH CASE ON WOMEN AND THE LEGAL PROFESSION

Those concerned with improving the situation of gainfully employed women hold two objects constantly in view. The one, more appealing, more concrete, more constantly inviting exertion, is the effort to obtain efficient and adequate protection for the great mass of untrained and unskilled girls and women who offer their services under conditions of real disadvantage in the labor market. The other object is that of